

STATE OF UTAH INSURANCE DEPARTMENT

REPORT OF FINANCIAL EXAMINATION

OF

GEM INSURANCE COMPANY

OF

SALT LAKE CITY, UTAH

AS OF

DECEMBER 31, 2000



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March 28, 2002

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State Corporation Commission
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Honorable Merwin U. Stewart, Commissioner
Utah Insurance Department
3110 State Office Building
Salt Lake City, Utah 84114

In accordance with your instructions and in compliance with statutory requirements, an examination, as of December 31, 2000, has been made of the financial condition and business affairs of:

GEM INSURANCE COMPANY

of

Salt Lake City, Utah

a life, annuity and disability stock insurance company, hereinafter referred to as the Company. The following report of examination is respectfully submitted.

Scope of Examination

Period Covered by Examination

The Company was last examined as of December 31, 1997, by representatives of the State of Utah Insurance Department. The current examination covers the intervening period from January 1, 1998, through December 31, 2000, including any material transactions and/or events occurring subsequent to the examination date noted during the course of the examination.

Examination Procedures Employed

The examination included a general review and analysis of the Company's operations, the manner in which its business was conducted, and a determination of its financial condition as of December 31, 2000. The examination was conducted in accordance with generally accepted standards and procedures of regulatory authorities relating to such examinations.

Status of Prior Examination Findings

Items of significance commented on in the prior examination report and their current status are summarized below:

1. The Company's board minutes did not evidence the replacing or dissolving of board committees. The Company did not provide documentation for board minutes held during 1997, and shareholder minutes held during 1995 through December 31, 1997. Current status: In 2000, the board of directors formed an investment committee. The board of directors kept minutes of their meetings during the examination period. The shareholder provided minutes of its meeting for 1998 and 1999. The shareholder, however, did not provide minutes for the 2000 meeting.
2. The Company's securities and repurchase accounts were not maintained in compliance with Utah Code Annotated (UCA) § 31A-4-108 and Utah Administrative Code (UAC) Rule R590-178. The examination recommends a custodial agreement be executed to satisfy statutory requirements. Current Status: As of the examination date, the Company's invested assets were being held under a custodial agreement which did not comply with UCA § 31A-4-108 and UAC Rule R590-178. In February 2002, the Company executed a custodial agreement that was compliant with UAC Rule R590-178.

History

General

The Company was incorporated on December 31, 1959, as a mutual benefit insurer called Gem State Mutual of Utah, and received a certificate of authority on April 1, 1960. The original working capital was provided by Utah resident policyholders of Gem State Mutual Life Association of Idaho.

During 1987 and 1988, Gem State Mutual of Utah was demutualized and liquidated. Gem Insurance Company and Gem Holding Corporation assumed the obligations of the mutual. The Company commenced operations as Gem Insurance Company on January 1, 1988.

On April 6, 1994, 99.9% of the common stock of Gem Holding Corporation was acquired by Intergroup Healthcare Corporation. During November 1994, Intergroup Healthcare Corporation merged with Foundation Health Corporation. Foundation Health Corporation was the surviving entity.

On May 30, 1995, the Company merged with an affiliate Intercontinental Insurance Brokerage, Inc. The surviving corporation was Gem Insurance Company.

On July 8, 1999, the Company amended and restated its bylaws.

As of December 31, 2000, the Company was a Utah domestic stock life insurance company which was a 100% wholly owned subsidiary of Gem Holding Corporation, a 100% owned subsidiary of Foundation Health Corporation, a wholly owned subsidiary of Health Net, Inc.

Dividends

Extraordinary dividends of \$15,000,000 in 1999 and \$8,000,000 in 2000 were paid to Gem Holding Corporation.

Capitalization

The number of shares of capital stock the Company was authorized to issue was 1,000,000 with a par value of \$1 per share. All 1,000,000 shares were issued to Gem Holding Corporation and remained outstanding as of December 31, 2000.

Management

The business and affairs of the Company, are managed by the board of directors. As of December 31, 2000, the board of directors consisted of:

<u>Name and Residence</u>	<u>Principal Occupation</u>
Cora Tellez Chairman of the Board Oakland, California	President Health Plans Division, Health Net, Inc.
William Corba Hollywood, California	President Foundation Health Systems Life & Health Insurance Company
George Di Salvo San Francisco, California	Senior Vice President/Treasurer/ Chief Financial Officer Health Net of California
Franklin Tom Los Angeles, California	Vice President/Secretary Health Net, Inc.

Officers:

Office
President

Officer
William Corba

Chief Executive Officer

Cora Tellez

Vice President/Treasurer

Roupen Berberian

Chief Financial Officer

Roupen Berberian

Vice President

Wisdom Lu

Chief Investment Officer

Wisdom Lu

Associate Vice President of Operations

Bruce Andersen

Secretary

Franklin Tom

Assistant Secretary

Eric Groen

Appointed Actuary

Thomas Attaway

Assistant Treasurer

Robin Simpson

Committee Established by the Board of Directors

Committee as of December 31, 2000:

Investment Committee

Steven Erwin

Wisdom Lu

Linda Salzman

B. Curtis Westen

Michael White

On April 10, 2000, the board of directors created an investment committee, but did not appoint the minimum three board members as required by Utah Code Annotated (UCA) § 31A-5-412(1).

Conflict of Interest Procedure

The Company has an established procedure for disclosure to its board of directors of any material conflict of interest on the part of its officers, directors or responsible employees. Under these procedures, each person is required to file an annual statement disclaiming or disclosing any material conflict of interest. However, the Company did not provide evidence that a conflict of interest statement was submitted for one officer for the years 1999 and 2000.

Corporate Records

The articles of incorporation and the bylaws were reviewed and were complete and specific as to the objectives and operations of the Company. The minutes of the annual shareholder meetings and periodic board of directors' meetings were reviewed and, in general, supported Company transactions and events. However, the shareholder did not have a 2000 shareholder meeting, which does not comply with Utah Code Annotated (UCA) § 16-10a-701.

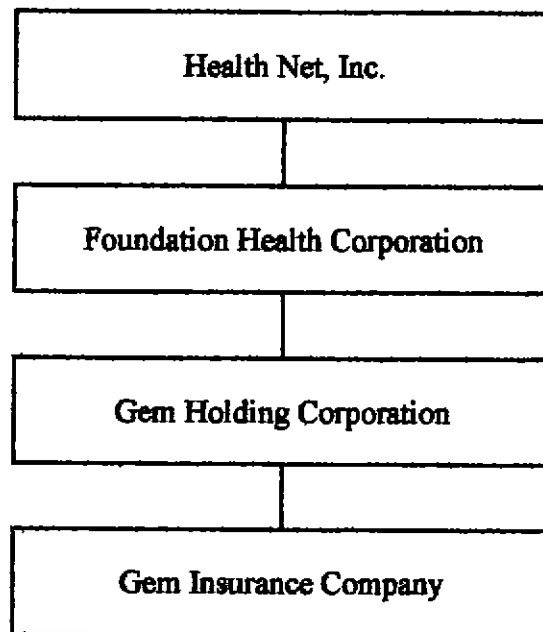
The Company's bylaws were amended and restated effective July 8, 1999. This was not disclosed in the Company's 1999 Annual Statement as required by Interrogatory # 18. There was no evidence that the amended and restated bylaws were filed with the commissioner as required by UCA § 31A-5-203(4).

Article III of the Company's amended and restated bylaws states "The Board of Directors shall consist of not less than three nor more than five members." However, Article VIII of the Company's articles of incorporation states that the board of directors shall consist of not less than three directors.

The board of directors meeting minutes did not disclose that the board members received a copy of the December 31, 1997, examination report issued by the State of Utah Insurance Department, which does not comply with the requirements of UCA § 31A-2-204.

Affiliated Companies

As of December 31, 2000, the Company was a member of an insurance holding company system as defined in Utah Code Annotated (UCA) § 31A-1-301(46). The Company's upstream parentage is illustrated in the following chart:



Transactions with Affiliates

The Company participated in a tax allocation and indemnification agreement with Foundation Health Systems, Inc. Foundation Health Systems, Inc. promises to file a consolidated federal income tax return on behalf of the "FHS Affiliated Group." The agreement requires each affiliate to pay Foundation Health Systems, Inc., an amount equal to the estimated separate tax liability of such subsidiary.

Pursuant to an administrative services agreement between Foundation Health Systems Life & Health Insurance Company and the Company, Foundation Health Systems Life & Health Insurance Company agreed to provide the Company with administrative support services, materials and supplies as may be requested from time to time and as may be necessary or appropriate to augment the administrative capacity of the Company. The Company is to reimburse Foundation Health Systems Life & Health Insurance Company, on a quarterly basis, for the actual cost and expenses incurred in furnishing or obtaining services, materials and supplies under the contract. However, the costs and expenses are not to exceed fifteen percent (15%) of the premiums received by the Company during the period to which the amounts payable relate.

The Company, in conjunction with Foundation Health Systems Life & Health Insurance Company and affiliates participates in a group life and accidental death and dismemberment reinsurance agreement with Hartford Life and Accident Insurance Company. Reinsurance is discussed below under the caption "Reinsurance Ceded."

Fidelity Bond and Other Insurance

The Company was covered under insurance carried by its parent, Health Net, Inc. (formerly known as Foundation Health Systems, Inc.) Those policies and the related coverage limits as of December 31, 2000, are listed immediately below:

<u>Type of Coverage</u>	<u>Limit</u>
Professional Liability Errors & Omissions	\$ 5,000,000 aggregate
Directors & Officers	5,000,000 aggregate
Fiduciary Liability	5,000,000 aggregate
General Liability	5,000,000 aggregate
Property Coverage	"Blanket" blanket limit

The amount of fidelity coverage recommended by the National Association of Insurance Commissioners for the Company was between \$75,000 and \$100,000. As of December 31, 2000, the Company's coverage satisfied the suggested minimum prescribed by the National Association of Insurance Commissioners.

Pension and Insurance Plans

The Company did not offer any pension, stock ownership or insurance plans.

Statutory Deposit

Pursuant to Utah Code Annotated (UCA) §31A-4-105, the Company was required, as of December 31, 2000, to maintain a deposit in the amount of its minimum capital requirement. The Company's minimum capital requirement was \$400,000 as determined by UCA §31A-5-211(2)(a). However, as of December 31, 2000, the Company maintained a deposit of \$255,000, which is \$145,000 less than the required minimum capital of \$400,000. The shortage of \$145,000 was a result of the Company selling a bond that was being held as part of its statutory deposit without the written approval of the Insurance Commissioner as required by UCA § 31A-2-206(10) and the tri-party agreement.

The following schedule presents the statutory deposit made through the Utah Insurance Department for the primary benefit of all policyholders as of December 31, 2000.

<u>Description</u>	<u>Statement Value</u>	<u>Market Value</u>
U S Treasury Note	\$ 249,729	\$ 255,000

Special deposits made by or through the respective state insurance departments not held for the benefit of all policyholders as of December 31, 2000, follows:

<u>State</u>	<u>Description</u>	<u>Statement Value</u>	<u>Market Value</u>
Arizona	US Treasury Note	\$ 99,891	\$ 102,000
Arizona	US Treasury Note	99,960	101,000
Arizona	Cash	300,000	300,000
Nevada	Gerber Products	99,154	99,154
Nevada	Maytag Corp.	100,000	100,000
New Mexico	US Treasury Note	149,837	153,000
		<u>\$ 848,842</u>	<u>\$ 855,154</u>

Insurance Products and Related Practices

As of December 31, 2000, the Company was in a run-off mode and was not issuing any certificates of insurance nor was the Company renewing any business.

As of December 31, 2000, the Company was licensed to transact life and accident and health insurance in the State of Utah. In addition, the Company held certificates of authority in Arizona, Colorado, Nebraska, Nevada, New Mexico, Oregon, and Texas.

Reinsurance

Assumed

The Company did not assume any insurance risk during the examination period.

Ceded

The Company obtained excess managed care coverage on its membership service agreements, but retained responsibility for its non-capitated indemnity health members, from Employers Reinsurance Corporation, a Kansas domiciled insurer and licensed in the State of Utah. The Company's retention was the first \$275,000 and 20% of the amount in excess of \$275,000 per person. The reinsurer's lifetime maximum liability per person was \$2,000,000 and the reinsurer's agreement period maximum liability per person was \$1,000,000.

The Company as an affiliate of Foundation Health Systems Life & Health Insurance Company obtained group life and accidental death and dismemberment coverage from Hartford Life and Accident Insurance Company. The Company's retention for group life insurance was \$75,000 per life. The reinsurer's maximum amount of automatic reinsurance in excess of retention for group life was \$1,000,000 per life. The reinsurer's maximum amount of automatic reinsurance for group accidental death and dismemberment insurance was \$1,000,000 per life.

The Company was contracted with Foundation Health System Life & Health Insurance Company to reinsure the Company's specific excess reinsurance and indemnity coverage. This agreement was terminated on December 31, 1999.

The Company was contracted with Foundation Health System Life & Health Insurance Company to reinsure the Company's specific excess reinsurance and indemnity coverage. This agreement was terminated on December 31, 1999.

Assumption

The Company obtained an assumption agreement to transfer all risks associated with their individual whole life policies in addition to their paid-up and extended term policies to Madison National Life Insurance Company. The assumption constituted a direct liability to each policyholder and the reinsurer issued and mailed, where applicable, a certificate of assumption to the policyholder.

Accounts and Records

The accounts and records of the Company consist of a general ledger, journals, registers, statistical records, and other records normally maintained by a life insurance company. Most of the records are maintained on a mainframe electronic data processing system. Data from the mainframe is used by the Company to prepare annual and quarterly statement exhibits, schedules, and other financial statements.

A trial balance was extracted from the accrual basis general ledger as December 31, 2000, and the accounts were reconciled to the Company's filed annual statement. Individual ledger accounts for the years 1998 and 1999 were reconciled individually as deemed necessary.

The Company retained the services of an independent certified public accounting firm to audit its financial and operating records for the 1998 and 1999 Annual Statement reporting periods. The Company was exempt from filing an audited financial report for the year 2000, since the Company had less than \$1,000,000 direct premiums written and had less than 1,000 policyholders.

Item eight, contained in the general section of the *Annual Statement Instructions* for life, accident and health companies promulgated by the National Association of Insurance Commissioners (NAIC), states, "If the annual statement and schedules do not contain the information asked for in the blank or are not prepared in accordance with these instructions, they will not be considered properly filed." In addition, Utah Code Annotated (UCA) § 31A-2-202(6) requires that "All information submitted to the commissioner shall be accurate and complete."

Reporting/financial reporting deficiencies noted by the examination included:

The Company stated on Schedule D – Part 2 – Special Deposits, that all deposits were being held for the benefit of all policyholders, claimants, and creditors. However, the Company should have reported the deposits for the States of Arizona, Nevada and New Mexico as not being held for the benefit of all policyholders.

One of the Company's bank accounts was being held in the name of Foundation Health Systems. The bank account should have been maintained in its own name pursuant to UCA § 31A-4-108.

The Company's 2000 Annual Statement, general interrogatories item # 23, disclosed that the Company maintained a complete permanent record of the proceedings of its board of directors and all subordinate committees thereof. However, the Company did not provide any meeting minutes for the investment committee.

Financial Statements

The following financial statements were prepared from the Company's accounting records and the valuations and determinations made during the examination:

Balance Sheet as of December 31, 2000

Summary of Operations -
for the Period Ended December 31, 2000

Reconciliation of Capital and Surplus Account -
January 1, 1998 through December 31, 2000

The accompanying Notes to Financial Statements are an integral part of the financial statements.

Gem Insurance Company
Balance Sheet as of December 31, 2000

QUALIFIED ASSETS

	<u>Amount</u>	<u>Notes</u>
Qualified Assets:		
Bonds	\$ 4,191,173	(1)
Preferred Stocks	102,000	
Cash and Short-term Investments	565,784	(2)
Federal Income Tax Recoverable and Interest Thereon from Affiliate		(3)
Investment Income Due and Accrued	63,512	
Receivable from Parent, Subsidiaries and Affiliates		(4)
Total Qualified Assets	<u>\$ 4,922,469</u>	

LIABILITIES, CAPITAL AND SURPLUS

Liabilities:		
Policy and Contract Claims: Accident and Health	\$ 38,165	(5)
Interest Maintenance Reserve	314,540	
Commissions to Agents Due or Accrued	1,982	
General Expenses Due or Accrued	173,868	
Taxes, Licenses and Fees Due or Accrued	3,000	
Asset Valuation Reserve	11,287	
Payable to Parent, Subsidiaries and Affiliates	17,557	
Drafts Outstanding	330,436	
Total Liabilities	<u>890,835</u>	
Capital and Surplus		
Common Capital Stock	1,000,000	
Gross Paid In and Contributed Surplus	76,657,426	
Unassigned Funds (Surplus)	(73,625,792)	
Total Capital and Surplus	<u>4,031,634</u>	(6)
Total Liabilities, Capital and Surplus	<u>\$ 4,922,469</u>	

Gem Insurance Company
Summary of Operations
for the Period Ended December 31, 2000

	<u>Amount</u>	<u>Notes</u>
Premiums and Annuity Considerations	\$ 529,955	
Net Investment Income	552,121	
Amortization of Interest Maintenance Reserve	28,017	
Miscellaneous Income	171	
Total	<u>1,110,264</u>	
Death Benefits		
Disability Benefits and Benefits Under Accident and Health Policies	278,425	(5)
Increase in Aggregate Reserves for Life and Accident and Health Policies and Contracts	(414,395)	
Commissions on Premiums, Annuity Considerations, and Deposit-type Funds	20,682	
General Insurance Expenses	898,718	
Insurance Taxes, Licenses and Fees, Excluding Federal Income Taxes	(57,021)	
Penalties and Fines	1,115	
Total	<u>727,524</u>	
Net Gain from Operations Before Dividends to Policyholders and Federal Income Taxes	382,740	
Dividends to Policyholders		
Net Gain from Operations After Dividends to Policyholders and Federal Income Taxes	382,740	
Federal Income Taxes	(373,988)	
Net Gain from Operations After Dividends to Policyholders and Federal Income Taxes and Before Realized Capital Gains or (Losses)	<u>756,728</u>	
Net Income	<u><u>\$ 756,728</u></u>	

Gem Insurance Company
Reconciliation of Capital and Surplus Account
January 1, 1998 through December 31, 2000

	<u>1998</u>	<u>1999</u>	<u>Per Exam 2000</u>
Reserves and Unassigned Funds December 31, Previous Year	\$ 22,360,992	\$ 23,952,126	\$ 9,266,282
Net Gain or (Loss)	1,974,764	(525,458)	756,728
Change in Non-Admitted Assets	(464,197)	843,585	(398,123)
Change in Asset Valuation Reserve	80,567	(3,971)	12,747
Dividends to Stockholders		(15,000,000)	(8,000,000)
Prior Period Federal Tax Adjustment			2,394,000
Net Change in Reserves and Unassigned Funds	<u>1,591,134</u>	<u>(14,685,844)</u>	<u>(5,234,648)</u>
Reserves and Unassigned Funds	<u>\$ 23,952,126</u>	<u>\$ 9,266,282</u>	<u>\$ 4,031,634</u>

Notes to Financial Statements

(1) Bonds

\$4,191,173

A bond of \$100,000 was reclassified to "Bonds" from "Cash" to be consistent with the *Annual Statement Instructions* for life, accident and health companies promulgated by the National Association of Insurance Commissioners.

Some of the Company's invested assets, held as of December 31, 2000, were not maintained in compliance with Utah Code Annotated (UCA) § 31A-4-108 and Utah Administrative Code (UAC) Rule R590-178. UAC Rule R590-178 specifies provisions required in the custodial agreement referenced in UCA § 31A-4-108(1). UAC Rule R590-178-5(B) states, "Custodial securities held in violation of this rule shall be disregarded in determining and reporting the financial condition of an insurer." In February 2002, the Company executed a custodial agreement, which was in compliance with UAC Rule R590-178. The referenced the invested assets were admitted for examination purposes.

(2) Cash

\$565,784

A bond of \$100,000 was reclassified from "Cash" to "Bonds," for examination purposes, to be consistent with the *Annual Statement Instructions* for life, accident and health companies promulgated by the National Association of Insurance Commissioners.

(3) Federal Income Tax Recoverable and Interest Thereon from Affiliate

\$ -0-

The Company reported unsecured recoverables from an affiliate for federal income tax recoverable in the amount of \$1,022,624. Unsecured recoverables are not recognized as a qualified asset pursuant to UCA § 31A-17-201. Accordingly, the unsecured recoverables are not recognized for examination purposes.

(4) Receivable from Parent, Subsidiaries and Affiliates

\$ -0-

The Company reported unsecured receivables from a parent in the amount of \$1,029. Unsecured receivables from a parent, subsidiary or affiliate are not recognized as a qualified asset pursuant to UCA § 31A-17-201. Accordingly, the unsecured receivable was not recognized for examination purposes.

(5) Policy and Contract Claims: Accident and Health

\$38,165

The aggregate amount of policy and contract claims reported by the Company, \$242,835, was decreased by \$204,670 to reflect the actual payout of claims through the eleven (11) months subsequent to December 31, 2000, but incurred on or prior to that date.

(6) Total Capital and Surplus**\$4,031,634**

The Company's December 31, 2000, filed Annual Statement reflected capital and surplus of \$4,850,617. Reserves and unassigned funds of this report are \$4,031,634 or \$818,983 less than reported by the Company. Examination changes to capital and surplus follow:

<u>Account</u>	<u>Examination</u>	<u>Company</u>	<u>Change in Capital and Surplus</u>	<u>Notes</u>
Bonds	\$ 4,191,173	\$ 4,091,173	\$ 100,000	(1)
Cash	565,784	665,784	(100,000)	(2)
Federal Income Tax Recoverable and Interest Thereon from Affiliate	-	1,022,624	(1,022,624)	(3)
Receivable from Parent, Subsidiaries and Affiliates	-	1,029	(1,029)	(4)
Policy and Contract Claims: A & H	38,165	242,835	204,670	(5)
Total Examination Changes			<u>\$ (818,983)</u>	
Capital and Surplus per Company			<u>4,850,617</u>	
Capital and Surplus per Examination			<u><u>\$ 4,031,634</u></u>	

The Company's minimum capital requirement was \$400,000 as defined under Utah Code Annotated (UCA) § 31A-4-105. As defined by UCA § 31A-17-VI, the Company had total adjusted capital of \$4,042,921. This was in excess of the authorized control level risk-based capital requirement of \$422,874.

Summary

Items of significance or special interest contained in this report are summarized below:


1. The Company's statutory deposit requirement was \$400,000. The deposit maintained was \$145,000 less than required. **(Statutory Deposit)**
2. Some of the Company's invested assets were not maintained in compliance with Utah Code Annotated (UCA) § 31A-4-108 and Utah Administrative Code (UAC) Rule R590-178. The Company, in February 2002, executed a custodial agreement that was in compliance with UAC Rule R590-178. **(Notes to Financial Statements)**
3. Some deficiencies in the Company's financial reporting and record keeping were noted. The Annual Statement must be prepared in accordance with NAIC instructions to be considered filed. **(Accounts and Records, Corporate Records and Statutory Deposit)**

4. The Company's minimum capital requirement was \$400,000 pursuant to UCA § 31A-5-211. Its total adjusted capital was \$4,042,921 and authorized control level risk based capital was \$422,874 pursuant to UCA § 31A-17-VI. (**Notes to Financial Statements**)
5. The board of directors' meeting minutes did not disclose that every member of the board of directors received a copy of the prior examination report. (**Corporate Records**)

Conclusion

The assistance and cooperation extended during the course of the examination by officers, employees and representatives of the Company is acknowledged.

Respectfully submitted,


Allen J. Hart, CFE
Senior Financial Examiner
Utah Insurance Examiner